Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:HOU:1AUS:TL-N-2615-01
CDInskeep

date: August 6, 2001

to: Heavy Manufacturing, Construction and Transportation,
Team [redacted] (LMSB)
ATTN: [redacted], Manager Stop 4320SANW

from: Associate Area Counsel
(Natural Resources:Austin) Stop 2000AUS

---

subject: [redacted] **Request for Advice**

This memorandum responds to your request regarding deductions claimed by [redacted] ("the taxpayer") for lease rejection damages. These deductions arise from transactions in connection with the taxpayer's purchase of interests in [redacted] in the [redacted]. This memorandum should not be cited as precedent.

ISSUE

What is the proper tax treatment for the amounts expended by the taxpayer to purchase interests in [redacted] of the [redacted] when the taxpayer held a leasehold interest in the items purchased?

FACTS

A comprehensive explanation of the facts is detailed in the attached summary memorandum prepared by Valuation Engineer John D. Cessna. The salient facts that are determinative for this analysis are that the taxpayer held leasehold interests in [redacted] and [redacted] of the [redacted]. During the taxpayer's bankruptcy proceeding and pursuant to a plan of reorganization, the taxpayer purchased the lessor's ownership interests in the [redacted] and terminated the leases. On its federal income tax returns for [redacted], [redacted], and [redacted], the taxpayer claimed deductions for the payments that had been made for the [redacted], characterizing the expenditures as "lease rejection damage." The total amount claimed for these deductions over the [redacted] year period is $[redacted].

Examination has proposed to disallow the claimed lease rejection damage deductions. The amounts paid by the taxpayer to

purchase the interests in the [redacted] would be recharacterized as expenditures for capital assets, deductible through depreciation over the useful lives of the purchased assets.

DISCUSSION

Examination's proposed adjustments to disallow the claimed "lease rejection damage" deductions are based on section 167(c)(2) of the Internal Revenue Code. This section applies to transactions occurring after its enactment on August 10, 1993. Subsection 167(c) provides:

> (c) Basis for depreciation.
> (1) In general. The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011, for the purpose of determining the gain on the sale or other disposition of such property.
> (2) Special rule for property subject to lease. If any property is acquired subject to a lease-
> (A) no portion of the adjusted basis shall be allocated to the leasehold interest, and
> (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.

Section 167(c)(2) prohibits the purchaser of <u>any</u> property subject to a lease from allocating any of the adjusted basis of the property to the leasehold interest. As explained in the legislative history, "The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property is to be taken into account as part of the cost of the tangible property." H.R. Rep. No. 103-111, at 769 (1993), <u>reprinted in</u>, 1993-3 C.B. at 345; <u>see also</u>, Treas. Reg. § 1.197-2(c)(8)(i).

As provided in the [redacted] for the taxpayer's bankruptcy proceeding, the taxpayer acquired property (i.e., the lessor's ownership interests in the [redacted]) while the property was subject to a lease. Thus, as a matter of law, section 167(c)(2) prohibits the taxpayer from allocating any of the purchase price of the property to the taxpayer's simultaneous acquisition of the leasehold interest in the property.

In prohibiting any allocation to the leasehold interest of the price paid for property subject to a lease, section 167(c)(2) does not distinguish between the tax treatment of favorable or

unfavorable leases, but denies such an allocation of purchase price in any acquisition of property subject to a lease. By its terms, section 167(c)(2) does not require that the leasehold interest remain in effect following the acquisition, but merely provides that the provision is applicable if the taxpayer acquires tangible property which is subject to a lease existing at the time of the acquisition.

Furthermore, under the plain text of section 167(c)(2), it would make no difference if the actual form of the transaction were disregarded and it was found that the taxpayer, in effect as lessee-in-possession, purchased property subject to the lease in order to cancel the lease. Section 167(c)(2) prohibits any attempt to dissect the purchase price into separate amounts paid for the tangible property and the leasehold interest and provides no exception for situations, such as in the instant case, where the acquirer also has an interest as a lessee in the property. Section 167(c)(2) establishes the simple rule that any taxpayer who acquires tangible property subject to a lease must allocate the entire purchase price to the basis of the tangible property.

The applicability of this provision to a similar factual situation was addressed in a recent Tax Court opinion, Union Carbide Foreign Sales Corporation v. Commissioner, 115 T.C. No. 32 (Nov. 8, 2000). In Union Carbide, the petitioner contracted to have a specially constructed seagoing vessel built for petitioner's use. The petitioner then sold the vessel and leased it back from the buyer. The petitioner subsequently decided that the lease had become onerous or burdensome. Under the terms of the lease, the petitioner was entitled to either terminate the lease by payment of a scheduled amount, or purchase the leased vessel; the petitioner decided to purchase the vessel. The transaction amount was $107,748,925.00, which was actually about twenty percent less than the payment required under the schedule to terminate the lease. The petitioner estimated that the value of the vessel at the time of the purchase was $13,865,000.00. For tax purposes, the petitioner allocated the transaction amount between the purchase of the vessel and the cost of terminating the lease. The $13,865,000.00 estimated value of the vessel was used as the basis of the acquired capital asset for computing depreciation. The remaining $93,883,295.00 of the amount paid was claimed as a current deduction by the petitioner as a lease termination fee.

The Service argued that section 167(c)(2) applied to the transaction, since the property was "subject to a lease" when it was acquired by the petitioner. The petitioner's position was that the statute applied to property that was subject to a lease when acquired, but only if the property would continue to be

subject to the same lease after the acquisition. In situations where property was acquired in order to terminate the lease, the petitioner argued that the provision had no applicability. The petitioner further argued that, disregarding the application of section 167(c)(2), the acquisition should be treated as though two separate transactions occurred: one transaction involved the payment of $13,865,000.00 for the acquisition of the vessel, and the other was the payment of $93,883,295.00 for the cancellation of the burdensome lease.

In a case of first impression regarding this issue, the Tax Court determined the intent and meaning of the phrase "If any property is acquired subject to a lease" and ruled that section 167(c)(2) applied to the petitioner's purchase of the vessel. The court found that the intended application of the statutory provision extended to property that was subject to a lease at the time it was acquired, regardless of whether the lease continued in effect or was to be terminated after the acquisition, even if the primary purpose of the acquisition was to terminate the lease. The court noted that the petitioner had the opportunity to formally terminate the lease with the lessor without acquiring the property, by exercising its lease cancellation option under the lease agreement. However, the petitioner chose not to do so, instead opting to achieve the same result by first purchasing the property and then terminating the lease. In effect, the court ruled that the petitioner had chosen the form of its transaction and must abide by the tax consequences of its actions.

The court also addressed petitioner's argument that the purchase should be viewed as two separate transactions, and that the portion of the purchase price exceeding the estimated value of the vessel should be treated as a separate payment, made to cancel the lease. The court analyzed this argument and determined that the weight of case authority did not support the petitioner's position, but was instead in harmony with the statutory provision of section 167(c)(2). Consequently, the Union Carbide decision clearly supports the application of section 167(c)(2) to a situation involving the purchase of property that is subject to a lease at the time of acquisition, even when, as in the instant case, the lease was considered burdensome by the lessee and the property was purchased by the lessee with the intention of terminating the lease.

In addition to the Union Carbide litigation, the Service recently has issued two written determinations which address the allocation of purchase price in situations involving the acquisition of power generating plants by utilities. Private Letter Ruling 9842006 and Field Service Advice 199918022 involved the effective cancellation of burdensome power purchase

agreements between regulated public utility companies and the power generating plants with which the utilities had contracted to purchase power. In both instances, the utility companies purchased the power plants in order to be rid of the burdensome power purchase agreements.

The Service allowed both taxpayers to characterize a portion of the purchase transaction amounts as costs incurred for the cancellation of the burdensome agreements, while requiring that a portion of the amounts be allocated to the capital costs of acquiring the power plants and other capital assets. The Service's position in these determinations was cited by the petitioner in Union Carbide as support for its argument that the amount paid for the vessel, purchased for the purpose of terminating the burdensome lease agreement, should be allowed as a deduction under I.R.C. § 162.

In Private Letter Ruling 9842006, a holding company owned a utility which had entered into agreements to purchase electrical power from a cogeneration facility. The power purchase agreements became burdensome due to changes in the power generation industry. The utility purchased the cogeneration facility in order to terminate the burdensome purchase agreements. The holding company sought to allocate a portion of the transaction amount as the cost of terminating the agreements. The Service agreed that the utility could deduct the portion of the amount paid that was allocable to the cancellation of the power purchase contracts. This portion was computed by determining the amount of the transaction price which exceeded the fair market value of the cogeneration plant.

Field Service Advice 199918022 involved a regulated utility that was required to enter into contracts with "qualified" power generating facilities for the purchase of power produced by those facilities. Because costs and rates were not accurately forecast, some contracts became unprofitable. The utility began negotiating to buy out the power contracts and eventually purchased a generating facility. The utility allocated a portion of the transaction amount to the purchase of the plant, and a portion of the amount paid was characterized as the cost of terminating the unprofitable power purchase agreements between the utility and the plant. Although disagreeing with the taxpayer's computations, the Service agreed that such an allocation was proper. A portion of the amount paid was allowed to be allocated to, and deducted as, the cost of terminating the power purchase agreements.

In response to the petitioner's reliance on these two determinations in the Union Carbide case, the Service pointed out

that neither of the two determinations involved the acquisition of property subject to a lease. Instead, both situations addressed the cancellation of power purchase agreements in connection with the purchase of the power generating plants. Consequently, the provisions of I.R.C. § 167(c)(2), which apply specifically when "any property is acquired subject to a lease," were not triggered by the transactions addressed in Private Letter Ruling 9842006 and Field Service Advice 199918022. The Court followed this reasoning in the Union Carbide opinion, and the same rationale applies in the instant case. Consequently, the two determinations do not affect the issue presented in the instant case.

The applicability of I.R.C. § 167(c)(2) in the instant case is dependent upon whether the leases were still in effect at the time of the taxpayer's acquisition of the interests in the [redacted]. This question is relevant because the property would not be "subject to a lease" when acquired by the taxpayer, if the leases had been terminated prior to the acquisition. Section 5.3(A) of the Fourth Amended Plan of Reorganization states that the leases "shall be deemed rejected as of the Effective Date [redacted]" to the extent that they "have not been previously rejected by operation of law or order of the Bankruptcy Court . . . ." The provision raises three possible scenarios concerning the termination of the leases: that they were terminated as of the effective date of the reorganization plan, or they had been terminated prior to the effective date by either the operation of law or the order of the court.

Each of these possibilities has been considered. With regard to the first, that the leases terminated or were rejected on the effective date specified in the reorganization plan, it is obvious that such an event could have occurred only when the acquisition was consummated on the same date. As part of the reorganization plan, the termination of the leases would occur only when, and if, the other provisions of the plan became effective, including the acquisition by the taxpayer of the interests in the [redacted], and the payment by the taxpayer of the amount agreed upon by the parties. It would have been detrimental to the status of the lessors if their leases had been terminated or if the transfer of their ownership interests had occurred, but the payment from the taxpayer did not take place. As a safeguard to the interests of the lessors, the taxpayer and the other creditors, the termination of the leases would have occurred only upon the acquisition of the [redacted] by the taxpayer and the payment by the taxpayer to the lessors.

Concerning the prior termination of the leases by the operation of law or order of the bankruptcy court, there is no

evidence that such events occurred, but rather the documentation supports a finding that the leases remained in effect until the other provisions of the reorganization plan were implemented. For example, the taxpayer's Form 10-Q for the period ending [redacted], stated that the lease payments were being expensed for financial reporting purposes. In its Form 10-K for [redacted], the taxpayer reported that, "[redacted]." No documentation has been presented to show an agreement between the lessors and the taxpayer to terminate the leases prior to the effective date.

The legal doctrine of merger would not terminate the leases prior to the acquisition, since the taxpayer's interest as lessee would not merge with the taxpayer's interest as lessor until the acquisition occurred. The legal concepts of surrender or breach apparently did not occur, since the lessors continued to provide power to the taxpayer under the lease agreements.

Furthermore, even if the taxpayer was able to show that the leases had been terminated prior to the acquisition date, it should not affect the characterization of the transaction amount. Although requested by Examination, the taxpayer has been unable to provide any document prepared for the acquisition transaction, such as a closing statement or settlement sheet, which shows a separate payment or any allocation of the transaction amount as a lease termination charge. Consequently, the entire amount would be attributed to the purchase of the capital assets and would be capitalized into the basis of those assets. This treatment has the same result, for tax purposes, as the application of I.R.C. § 167(c)(2).

CONCLUSION

The proper tax treatment for the amounts expended by the taxpayer to purchase the interests in the [redacted] of the [redacted] is to characterize the amounts paid as capital costs for the acquisition of capital assets. The costs may be added to the taxpayer's bases in the assets and recovered through depreciation. This characterization of the payments as capital expenditures by the taxpayer is appropriate, even though the taxpayer held leasehold interests in the items purchased and intended to terminate the leases after acquisition of the property.

We hope that this response satisfactorily addresses your inquiry. If you have any questions or comments, please contact the undersigned attorney at (512) 499-5324.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

MARION S. FRIEDMAN
Associate Area Counsel
(Large & Mid-Size Business)

By:_____
CARL D. INSKEEP
Senior Attorney (LMSB)

Enclosure:
As stated